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TAGS: ECON EFIN ETRD TH
SUBJECT: THAI ECONOMY CONTINUES TO SLOW

REF: A. BANGKOK 3463
¶B. BANGKOK 2137
¶C. BANGKOK1266
¶D. BANGKOK 1237

¶1. Sensitive but Unclassified. not for Internet Distribution.

¶2. (SBU) Summary: Increasing oil prices exacerbated a turn in Thailand's business cycle resulting in GDP growth of 3.3 percent in 2Q 2005. Continued declines in consumer and business sentiment caused weakness in consumer spending and private investment leaving 12 percent growth in imports as the primary source of economic strength. The 35 percent increase in imports, primarily oil, more than offset the export growth and resulted in a large Current Account deficit over the fist half of the year. The Bank of Thailand is expected to increase its policy interest rate by as much as 1 percent by year-end in a bid to control inflation, maintain stability in the baht and reduce the negative spread between nominal and real interest rates. This is somewhat at cross-purposes with RTG policy which would prefer a relatively weaker baht and continued low interest rates to augment the fiscal stimulus policies it has put in place. Economists have reduced 2005 GDP growth forecasts to 3.5-4.5 percent from 4.5-5.5 percent thre
e months earlier. We believe that the government's strong fiscal position, commercial bank's improved financial condition and strong corporate balance sheets will see Thailand through what the Bank of Thailand terms "the year of adjustment which tests the economy's resilience." The main risk factors to this upbeat scenario are continued increases in world oil prices and weakening in the economies of Thailand's major trading partners. End Summary.

Economy Growing More Slowly

¶3. (U) The Thai economy grew 3.3 percent in the first quarter compared to the same period last year, and declined 0.6 percent from the last quarter of 2004. Initial projections for the 2nd 2005 quarter show no improvement. This continues a trend of declining GDP growth over the past 1.25 years. The Bank of Thailand attributes the relatively poor economic performance so far this year primarily to the increase in world energy prices. This global problem has been exacerbated in Thailand by the effects of the December 26 tsunami, drought in certain agricultural regions and the on-going violence in three far southern provinces of the country. In addition, the global economy grew only modestly over the past year limiting growth opportunities for Thai exports.

The Fallout from High Oil Prices

¶4. (U) There is no doubt that the rise in oil prices has been a major contributor to Thailand's swing to deficit in its current account, from a US$7.1 billion surplus in 2004 to a US$6.2 billion deficit in 2005's first half. Foreign exchange reserves have declined modestly over the first half from US$49.8 billion to US$48.4 billion-about 3.5 months of imports; 3.6 times short-term external debt. Analysts estimate that oil costs have doubled, going from 4 to 8 percent of GDP and subtracting about 5.5 percent from the country's rate of growth. Oil has accounted for more than 33 percent of total Thai imports this year. In addition, the cost to Thai consumers and businesses was more keenly felt than were last year's increases in world energy prices due to the end of the RTG's subsidy on diesel beginning on July 13. Diesel prices at the pump have increased 4.1 percent and would have been up by around 10 percent had excise taxes on the fuel not been reduced at the same time as the subsidy ended. According to the B
ank of Thailand, the increase in fuel prices has been the key cause of inflation rising to 5.3 percent in July (core 1.9 percent). 2004 headline inflation was 2.7 percent.

¶5. (SBU) The deficit in the current account, rising prices and the negative news from natural causes have all taken a toll on consumer and business sentiment. Both these

indicators have been declining for the past six quarters and business sentiment is at its lowest point since 2001. This is reflected in both the Private Consumption Index (growing at only 0.3 percent in 1H 2005) and low rates of fixed asset formation, even though capacity utilization continues to run above 70 percent. Consumer purchasing power going forward will be further constrained by recent Bank of Thailand moves to restrict credit growth in the sub-prime market (from concern that these consumers were becoming over-extended) and interest rates that are expected to increase 75-100 basis points by year-end as the Central Bank tries to rein in inflation and increase savings by reducing the 3.5 percent negative spread between real and nominal short-term interest rates. The Monetary Policy Committee (equivalent in function to the U.S. Federal
Open Markets Committee) is faced with pressure to raise interest rates to protect the value of the Baht and reduce inflation even as the RTG is anxious to keep rates at a level that continues to be a stimulus to the economy.

Fiscal Stimulus, But Not Much This Year
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¶6. (SBU) As reported in reftels, the RTG must identify the next driver for economic growth now that consumers are nearing their maximum debt levels and private investment is not picking up the slack. While most analysts are sanguine that recent positive growth in the economies of Thailand's major trading partners should translate into a renewed upsurge in Thai exports, we question the ability of Thailand to meet any significant increased demand given the lack of investment in increased capacity. The government's five-year "megaprojects" infrastructure development program remains on the drawing board at this point, slowed by the huge size of the proposed projects, the need to create institutional capacity to manage several large projects simultaneously, the RTG's desire to postpone projects requiring large amounts of imported inputs while the current account is in deficit and reported in-fighting over which companies will be awarded these contracts. Analysts don't expect any real progress on these projects un
til sometime in 2006.

¶7. (SBU) To stimulate the economy this year, the government is taking the following actions:
-Bt50 billion accelerated disbursement of RTG budget.
-5 percent increase in salaries of civil servants
-5 percent increase in pension payments
- 3.5 percent increase of the minimum wage
- Directing state-owned commercial banks to accelerate a loan expansion program (Note: Most commercial banks have tightened lending standards for loans to SMEs in anticipation that slower economic growth could result in tougher trading conditions for small companies and, therefore, more potential loan defaults. End note.)
-Increase in the "Village Fund" program to direct more funds to rural areas.
Due to a balanced budget, a government debt/GDP ratio of around 45 percent, and continued strong growth in government revenue (up 10 percent in 1H 2005), the RTG has the fiscal wherewithal to undertake these programs without undue risk.

¶8. (SBU) Newly appointed Finance Minister Thanong Bidaya has pledged to make financial stability his key concern. However, he has also said that he is investigating means to reduce consumer debt burdens. While it is unclear how he will accomplish this, some analysts are concerned that it will result in some sort of socialization of consumer debts as a means to provide consumers with the ability to re-leverage themselves and again act as a stimulant to the domestic economy through their renewed purchasing power. Meanwhile, private commercial banks have tightened up their standards and practices for consumer loans and credit cards. The RTG is also studying ways to restructure the debt of small farmers suffering from drought. We expect that this will be extended to small farmers in general via the RTG-owned special purpose banks (Bank for Agriculture and Agricultural Cooperatives and the Government Savings Bank.) Note: The rural areas are the political base of PM Thaksin and his party. End Note.

Oil Anomaly

¶9. (SBU) To reverse the current account deficit, the RTG has asked Thai Airways to delay purchase of two A340 jets and requested importers not to stockpile goods, especially oil, gold and steel which have been major contributors to the deficit. We noted that customs statistics show the value of energy imports in 1H 2005 increased over 80 percent in dollar terms and over 100 percent in May and June from the previous year. The increase in oil prices only account for about 60 percent of this increase in imports. Meanwhile, the Ministry of Energy reports that overall domestic demand for refined product declined 16 percent over the 1H 2005 in response to a slowing economy and increased prices and that there was no

net increase in oil imports. The official Bank of Thailand explanation for this anomaly is that Thai customs is reporting imports in arrears with a mismatch between when oil is contracted, imported and accounted for while the Ministry of Energy records imports based on invoice dates. Industry contacts also suggest that 2004 customs statistics understate imports, thereby distorting year-over-year comparisons.

¶10. (SBU) A different explanation put forward by some analysts is that oil companies may have been importing large amounts of oil (stockpiling) earlier in the year to gain inventory profits, i.e. they import crude at prices prevailing earlier this year but sell refined product later in the year and price the refined product at the then (higher) prevailing world prices. There is little available excess crude storage capacity in Thailand so, if this sort of speculation did in fact occur, it could not have accounted for a 40 percent increase in oil volume imports. Contacts familiar with the petroleum refining industry in Thailand have suggested that the reason for increased oil imports is that at current prices and refinery margins Thailand is exporting refined petroleum products to other countries in the region, although Energy Ministry statistics don't support this theory. Finally, some say that because the subsidy on diesel caused fuel to sell for below market prices in Thailand, some smuggling of product to neighboring countries took place. The RTG has repeatedly stated that they expect oil import bills to decline the second half of the year in response to energy saving measures and "closing loopholes" in accounting.

¶11. (SBU) Comment: Most analysts expected the Thai economy to weaken through the first half of the year (reftels) and they have proven correct. Now they are anticipating recovery in the second half. They expect the government's relatively modest fiscal stimulus, combined with somewhat improved export performance, a recovery in tourism to tsunami-affected regions and moderation of imports to bring the current account deficit down to around US$3 billion by year-end. The US$2.6 billion net increase of foreign portfolio investment this year also displays some degree of investor confidence going forward (although at least some of this is probably speculation based on Yuan appreciation using the Baht as a proxy). Finally, bankers tell us that they have seen no deterioration in loan performance to date. The Bank of Thailand is carefully monitoring the lending of state-owned banks to ensure proper credit standards are maintained in the face of RTG pressure to increase loan volumes. So far, this pressure seems to be m
ostly talk as part of the government's efforts to reverse negative public sentiment about economic prospects.

¶12. (SBU) Nevertheless, we believe that there are significant risks to the positive scenario; above all the price of oil which would both further increase Thailand's import bill and negatively affect Thai export market's ability to grow. If growth stays below 4 percent for more than another year, there is a strong likelihood that NPLs would again rise as companies fail to grow at anticipated rates and restructured loans return to default status. While we believe banks have rebuilt their collateral and reserves to levels sufficient to deal with this problem, the effect on sentiment could exacerbate current confidence problems.

¶13. (SBU) There are no discernable bubbles in the Thai economy, but there are also few signs of robust growth in the short-term. Consumers will be hit by increases in interest rates and high energy prices, the real estate construction boom is slowing and domestic manufacturers still show no evidence that they are willing to invest in any major expansion. In 2001 Thaksin was successful in bringing Thailand back economically through policies that stimulated domestic consumption while export markets recovered. Now, Thailand is returning to a period where it must rely on export markets for growth until RTG infrastructure spending kicks in. The government is keenly aware of the risks of overdependence on the performance of other economies in this "year of adjustment which tests the economy's resilience." End Comment.
BOYCE